Quarterly Outlook

Q2 2022

SAXO GROUP

The End Game has arrived

Content

Q2 2022 outlook: The end game has arrived

An Executive Summary
Our outlook for Q2 2022 argues that we are witnessing nothing less than the arrival of the end game for the paradigm that has shaped markets since the advent of the Greenspan put in the wake of the LTCM crisis of 1998. The twin shocks of the pandemic and Russia's invasion of Ukraine have shifted priorities on all policy fronts, including fiscal, monetary and geopolitical. In the US, the imperative for the Fed to grapple with spiralling inflation risks has disrupted the traditional rinse and repeat of bailing out financial markets and the economy at the first ripple of trouble. Shortly put, the strike price of the "Powell put" is far lower than it was a year ago—the Fed must get ahead of the curve. In Europe, the Russian invasion of Ukraine has seen Germany tossing decades of fiscal and defence policy out the window, ushering in a new era of investment that should drive a strong rise in productivity. EU existential risks have disappeared as defence priorities soar above all other considerations. Helmets on, as 2022 will prove a wild ride for global markets.

Our macro outlook picks apart the argument that we are seeing a repeat of the 1970s as the world faces a supply shock unlike any it has previously seen. It's one that risks a "great erosion" as negative real rates erode purchasing power on all levels and rising costs erode profit margins for corporations. Productivity must eventually improve to address this, but the prospects for productivity gains from the green transition are questionable.

In fixed income, the outlook focus is on the rapid flattening of the US treasury yield curve as an inversion threatens and points to rising recession risks. We also look at rising yields across Europe on a less accommodative ECB and, given the new fiscal expansion, what this could mean for EU peripheral spreads. In the credit space, central bank tightening will continue to turn the screws on credit spreads, possibly risking a tantrum at some point.

In equities, our focus is on equity valuations under siege from supply-side constraints, rising input costs and the prospect of far higher interest rates. Winners from here will be companies that can boast strong innovation, pricing power and profitability. In Europe, companies that absorb the enormous new fiscal push in defence, energy and other industries will likely benefit. We also present a special feature piece on cybersecurity, an industry that was already booming before Russia's invasion super-charged focus on cybersecurity vulnerabilities on all levels—government and corporate.

In commodities, the focus is on the continued upside risk for oil that was already in place before the Russian invasion of Ukraine badly aggravated forward supply uncertainty. We also look into a supportive backdrop for industrial metals on the priorities of new military spending, the metal-intensive green transition and—as Russian supplies are disrupted—on sanctions. Elsewhere, rising food prices remain a risk as a corollary of rising energy prices, but also if this year's Ukrainian wheat crop can't get to market, as it is a major exporter. The gold story remains bullish as an inflation hedge and as long as real rates remain negative.

In currencies, the focus is on the potential comeback for the euro on the massive shift in fiscal outlays that has been triggered by the Russian invasion of Ukraine. This will keep more of EU savings in the EU and deepen capital markets there. We also break down how spiralling inflation and the sanctions against Russia's central bank have likely accelerated the move away from USD primacy as the global reserve asset of choice.

Finally, this outlook features a rundown of the technical outlook for important assets from gold and crude oil to US equities, and in particular the remarkable multi-decade perspective on the Dow Jones Industrials.

Saxo
Strats

Steen Jakobsen first joined Saxo Bank in 2000 and has served as both Chief Economist and Chief Investment Officer since 2009.

He focuses on delivering asset allocation strategies and analysis of the overall macroeconomic and political landscape as defined by fundamentals, market sentiment and technical developments in the charts.

@Steen_jakobsen

The end game has arrived

Steen Jakobsen // Chief Investment Officer

The global economy has suffered two major shocks in the short space of two years: The Covid pandemic in 2020 and the war in Ukraine in 2022. Both will have a tremendous impact on markets and especially on economic policy as these shocks have created new geopolitical priorities by exposing huge vulnerabilities in what turns out to have been an excessively tuned globalised economy. This outlook addresses the tectonic shift already underway in global macro and politics. Gone are the days of ever-falling real interest rates and ever more financialisation, to be replaced by a new rise in productivity as we move the economic agenda to a better and more rational place, despite the gruesome humanitarian news we get day by day from the war in Ukraine.

The starting point for this paradigm shift is that the fiscal restraints that have been a central premise in global economic policies since the 1990s are now gone! The shift was already enormous during the pandemic, but was most stark in the case of the German response to the war in Ukraine. Chancellor Scholz tossed decades of fiscal orthodoxy out of the window in a speech before an emergency Sunday convening of the Bundestag, committing Germany to massive new defence spending and diversification of its energy imports. Now we have the full power of government coming down the pipeline, ending the era when the onus was entirely on the private sector for economic growth.

This is by no means a blessing of what is going on (more deficits), but a reaction to the recent one-two punch of the pandemic and a hot war in Europe bringing with it enormous implications. Foremost among these will be higher productivity gains through new military and energy spending that will increase the full economy's net spending on infrastructure, basic research and innovation. Take Germany's sudden commitment to upgrading its armed forces. This is the country with internet connections so slow that they couldn't home-school during Covid lockdowns. I predict that, through its newfound focus, Germany will be a leader in digital and communications inside the next three years, simply because they must if they want to optimise defence infrastructure.

Many may not realise that the fall of the Berlin Wall in 1989 brought with it a collapse in not only military spending, but also basic research. In the private sector, the focus shifted to constant schemes to boost dividends and buyback schemes that optimised short-term returns. Now, strategic goals will force investment into long-term planning, and with it basic research which will benefit the private sector both in terms of flow of investment funds and innovation spinning from it. Products such as Teflon, Gore-Tex, the internet, GPS and many other basics of modern life started in military research labs.

Let me underline that my belief in the potential benefits of military spending is based on the hope that it can act as a deterrent and on what civilian economies can gain from it, not because I am hoping for increased tensions. I would even argue that this paradigm shift from buybacks to basic research, from short-term gains to strategic resilience, and not least from non-productive to productive, will not only leave the economy in better shape but in the longer term will reduce inflation risks and improve price discovery.

Through the years, the Saxo Strategy Team has always argued that "shocks" are a necessary catalyst for any real change—and these twin shocks will prove to have marked the end of an era. That era began in 1998 when Chair Greenspan bailed out LTCM and in the process created a policy model in which every crisis was met by easier financial conditions which brought no real CPI inflation, even if they did create new asset bubbles that ensured the cycle would rinse and repeat. This cycle died in November 2021 when the Fed and the White House finally got the inflation in everyday goods that all of the previous cycles had avoided. This time the old policy response won't work, which is why we have the Fed initiating a new rate hike cycle despite US equity markets under severe strain with inflation at a 40-year high. This is the most significant pivot point for geopolitics and markets since at least the Berlin Wall falling in 1989 and China's inclusion in the WTO in 2001.

I will argue that it's even bigger as the double whammy of Covid and the war in Ukraine has created the necessary conditions for a macro pivot away from the trend of falling real rates that began all the way back with Fed Chair Paul Volcker's victory over inflation in the early 1980s. This trend deepened badly into non-productive negative real rates territory in the wake of the global financial crisis and deeper still as inflation broke out with a vengeance after the Covid pandemic. Positive real rates are a necessary precondition for higher potential growth without inflationary costs. Both the fall of the Berlin Wall and China's WTO entry was really an arbitrage of the cost of labour and energy. The fall of the Berlin Wall created a bigger world with fewer borders to trade and cheaper labour, and the WTO admission of China took this one step further, adding even more cheap labour and cheap energy (China's explosion of cheap coal-based production). The potential gains from these new forces were already well diminished and even in reverse before Covid, and productivity was on the decline due to over-financialisation, rent-seeking, zombification of companies: all hallmarks of negative real rates. Now, the supply-side shocks of Covid and the war in Ukraine have accelerated our path toward more productivity. Policy simply must take us toward more price discovery and positive real yields as market and government actors fight for investment in a world we now understand is highly constrained by absolute energy, environmental and capital limits.

I am probably too early in prognosticating this necessary shift and I fear a runaway inflation end game before we get to the point described above; central banks are not only late to the party but may have entirely missed the opportunity to bring down inflation in the medium term. Into this reality there is now a dire need for central banks to stop chasing inflation from behind and to get ahead of the curve. This will mean communication and actions that increase the "risk-free rate" dramatically. The market hopes or prays that this will end as demand destruction kicks in, but how can it? The US S&P 500 in price/earnings terms is still at the 80th percentile (extremely expensive), housing prices are at all-time highs, as are art, fine watches and—not least—the savings and investment accounts of the average investor. And as if that were not enough, governments are now moving to mitigate the costs to lower-income households of rising energy. This is done with good intentions but is unproductive in the long run as demand remains high and will only make energy even more expensive.

In conclusion we have three cycles simultaneously impacting the market:

1. The ongoing supply crunch from Covid and the war in Ukraine, but also from the world's physical limits
2. The repricing of assets against a backdrop of rising inflation
3. The new Fed tightening cycle lifting off in March and set to continue

These will eventually lead to two key outcomes

- Strategic macro policies: an increase spending on energy and defence priorities, but also supply chain diversification to remove single points of failure for strategic industries.
- Negative real rates turning more positive as an indication that the global economy is set for a major productivity boost, away from short-term financial gains and rent seeking and toward tangible assets, infrastructure and a reaffirmation of the social contract.

Let me end by saying I am the most optimistic I have been in my 35 years of business, but for one reason only: I don't think it get can get much worse.

Steen Jakobsen

PS: I have actively decided not to comment on the war in Ukraine specifically, but everyone should know that the SaxoStrats team and I believe in freedom and self-determination, and the Russian invasion of Ukraine violates those principles.

Saxo
Strats

Peter Garnry joined Saxo Bank in 2010 and is the Head of Equity Strategy.

In 2016 he became responsible for the Quantitative Strategies team, which focuses on how to apply computer models to financial markets. He produces trading strategies and analyses of the equity markets as well as individual company stocks, applying advanced statistics and models to beat the market.

@PeterGarnry

Productivity, innovation and pricing power have never been more important

Peter Garnry // Head of Equity Strategy

Equity valuations are under siege

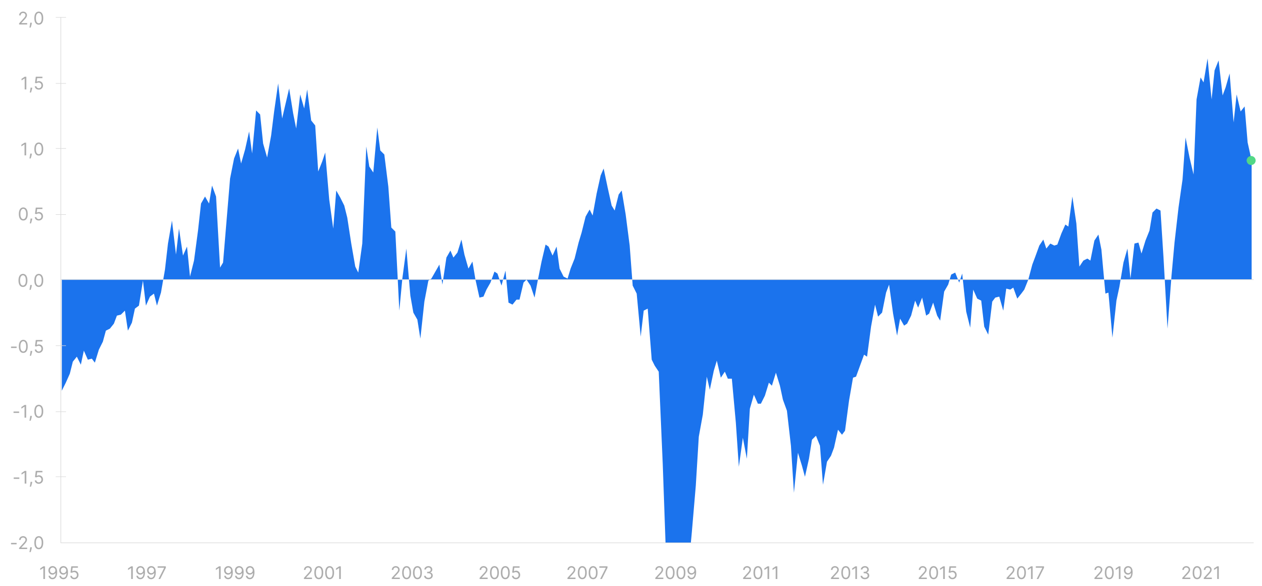
Before Russia's invasion of Ukraine equities were already under pressure from rising commodity prices and a worsening interest rate outlook. The war and subsequent severe sanctions against Russia have catapulted the world into an unpredictable and maximum uncertainty environment. When the future becomes more uncertain the precautionary principle dictates that the equity risk premium should go up, with equity valuations going down as a consequence.

Equity valuations are primarily driven by four factors: revenue growth, EBITA margin, incremental investment needs, and the discount rate on future cash flows. While the ongoing inflationary pressures might push up nominal revenue growth, the three other factors are all moving in the wrong direction.

Rising input costs for companies across raw materials, energy and wages are not only making operating margins more volatile; they will also compress margins—we have already observed this in the Q3 and Q4 earnings. As there has been underinvestment in our physical world for over a decade (the capital expenditures in the global energy and mining sector are historically low) and global supply chains will be reconfigured amid rising geopolitical tensions, incremental investments will likely move higher. Central banks have severely underestimated inflationary pressures as the world economy has exhausted the low-hanging benefits from globalisation and prior investments. The world economy has clearly hit physical limits and this is causing inflationary pressures. Central banks will have to reduce demand through tightening financial conditions which include higher interest rates and a higher discount rate on future cash flows. All of the above will lead to lower equity valuations.

MSCI World Index

Average Z-score across seven valuation metrics



Source: Bloomberg and Saxo Group

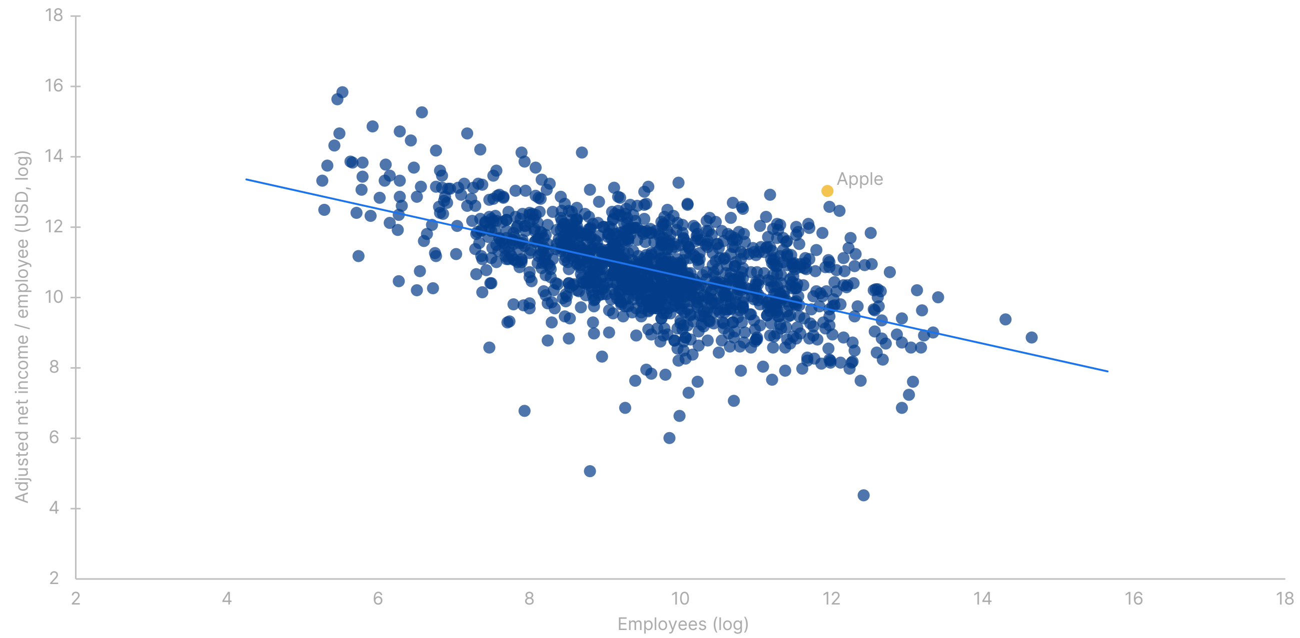
Despite the vector of all the most important factors for equity valuation pointing in a negative direction, as of February 2022 the MSCI World Index is still valued 0.9 standard deviations (equivalent to the 86th percentile on valuation) above its historical average since 1995. Given the outlook and opportunity set we believe equities should be valued closer to their historical average, reflecting the increased uncertainty and difficulties modelling growth and margins. This means an additional 10-15 percent downside in the MSCI World Index.

It's all about productivity and innovation

With a large-scale war back in Europe and commodity markets in upheaval, this has aggravated inflationary pressures and equities have entered an environment not seen since the 1970s. High inflation is essentially a tax on capital and raises the bar for return on capital, and thus inflation will filter out weaker and non-productive companies in a ruthless fashion. The days of low interest rates and excess capital keeping zombie companies alive longer than necessary are over.

Reading Warren Buffett's shareholder letters from the 1970s the key to survival is productivity, innovation or pricing power. The latter is often a function of productivity and innovation, and coincides with high market share—or just size in general—providing economics of scale. Over the past year we have frequently mentioned mega caps as a theme during inflation. The largest companies in the world are the last to get hit from tighter financial conditions, and they also have the pricing power to pass on inflation to their customers for a longer time than smaller companies.

Productivity across companies in the North America and Europe



Source: Bloomberg and Saxo Group

> **With a large scale war back in Europe and commodity markets in upheaval aggravating inflationary pressures, equities have entered an environment not seen since the 1970s**

Besides raw size as way to survive inflation and higher interest rates, companies that are productive will have a higher chance of survival. Productivity can be measured in many ways, but in order to have a uniform measure that can be used across all industries we have looked at adjusted net income to employees. This measure can be plotted against the number of employees and will show a negative relationship. This means that the larger a company gets the lower its profits per employee get. In order words, there are diminishing returns to size, which should not be a surprise. If a company is trying to maximise profits then that will often naturally lead to sacrificing productivity; but what is lost in productivity is gained through economies of scale in its operations, and this allows for higher levels of aggregated profits. Companies that lie way above the regression line (see plot) are those that have significantly higher profit per employee (productivity) relative to what their size would suggest. The most productive company in the world relative to what its size would dictate is Apple (orange dot). The companies that are way above the regression line are doing something right. In our productivity and innovation table below, we show the two best companies in each industry group that have the largest spread above the regression line.

Saxo's productivity and innovation list

Productivity

Name	Market cap (USD mn.)
Apple Inc	2.458.034
Microsoft Corp	2.072.434
Alphabet Inc	1.670.339
NVIDIA Corp	533.250
Meta Platforms Inc	507.996
UnitedHealth Group Inc	459.084
Visa Inc	433.615
Walmart Inc	399.577
JPMorgan Chase & Co	384.367
Procter & Gamble Co/The	347.694
Home Depot Inc/The	332.444
Bank of America Corp	332.272
Coca-Cola Co/The	253.771
Costco Wholesale Corp	233.114
Cisco Systems Inc/Delaware	225.571
Verizon Communications Inc	220.386
Intel Corp	180.797
McDonald's Corp	168.184
AT&T Inc	163.501
NextEra Energy Inc	155.606
Morgan Stanley	150.912
Honeywell International Inc	125.642
Lockheed Martin Corp	119.692
Unilever PLC	115.235
Goldman Sachs Group Inc/The	114.563
Rio Tinto PLC	112.027
Altria Group Inc	91.844
Booking Holdings Inc	81.773
Gilead Sciences Inc	72.914
Cigna Corp	72.600
AP Moller - Maersk A/S	66.561
Moderna Inc	60.481
Hapag-Lloyd AG	60.079
General Motors Co	59.327
Newmont Corp	58.443
RELX PLC	54.991
Bayerische Motoren Werke AG	53.243
Thomson Reuters Corp	49.847
Aflac Inc	39.538
Cheniere Energy Inc	32.688
eBay Inc	30.604
DR Horton Inc	27.420
Lennar Corp	24.011
Power Corp of Canada	20.634
Chesapeake Energy Corp	9.761
NRG Energy Inc	9.369

Innovation

Name	Market cap (USD mn.)
Amazon.com Inc	1.443.622
Nestle SA	349.014
L'Oreal SA	201.736
AT&T Inc	163.501
Booking Holdings Inc	81.773
Schlumberger NV	58.711
Orsted AS	52.330
Synopsys Inc	42.711
Dexcom Inc	39.534
Cadence Design Systems Inc	38.594
Ferrari NV	35.469
Verbund AG	35.130
Experian PLC	35.099
Coinbase Global Inc	33.622
Electronic Arts Inc	33.502
Deutsche Boerse AG	32.236
eBay Inc	30.604
Veeva Systems Inc	26.261
Las Vegas Sands Corp	24.516
Beiersdorf AG	23.696
CoStar Group Inc	22.100
Genmab A/S	21.699
Garmin Ltd	21.083
Kerry Group PLC	18.875
Novozymes A/S	17.073
Incyte Corp	15.977
Tenaris SA	15.886
Continental AG	14.070
Hasbro Inc	12.067
Juniper Networks Inc	10.745
Elisa Oyj	9.441
Chr Hansen Holding A/S	9.217
Synaptics Inc	7.824
Lattice Semiconductor Corp	7.024
OSRAM Licht AG	6.027
Leonardo SpA	5.735
Ubisoft Entertainment SA	5.271
National Instruments Corp	4.857

* Companies in the productivity category are chosen as those two companies with the highest productivity (adjusted net income to employee) relative to their number of employees measured against all companies in North America and Europe.

** Companies in the innovation category are chose as the two companies in each industry group with the highest R&D in percentage of revenue. Some industry groups such as banks and insurance have been excluded because companies in those industries are not recognizing R&D.

Source: Bloomberg and Saxo Group

There's a vast amount of academic literature linking research and development (R&D) intensity to future equity returns; many studies have found a positive relationship regardless of the intensity measure used. In our analysis we have chosen to use R&D in percentage of revenue as a measure of R&D intensity and as with our productivity ranking, we have selected the two companies from each industry group with the highest R&D intensity; certain industry groups with no R&D such as banks and insurance have been excluded. The productivity and innovation list should not be viewed as an investment recommendation but as an objective list highlighting companies that score the highest on our chosen metrics for productivity and innovation. These measures are not guaranteed to lead to outperformance in the future.

Europe's seismic shift in security policy

For decades to come February 24, 2022 will mark the pivotal moment when Europe's post-WWII security policy changed as Russia launched a full-scale invasion of Ukraine. In each decade following WWII, European countries inside NATO had lowered their military spending as a percentage of GDP to the point that it reached only 1.2 percent in 2019, compared to the US at 3.7 percent in 2020. This significant discrepancy—despite the NATO agreement in 2006 to commit to a minimum 2 percent of GDP—was the culprit behind the attacks by former US President Trump on NATO and European countries for doing too little. Europe had long argued that they spent money in non-direct military areas that had a security purpose inside NATO, but there is nothing like a black swan event to reveal that the emperor has no clothes.

Following Russia's invasion of Ukraine all countries in Europe have said that the continent has changed, and it is clear that they must step out from under the US military umbrella. Germany has declared that it will indefinitely increase military spending to above 2 percent of GDP, signalling a major security policy shift. The 27 countries in the European Union spent €168bn in 2019, and if military spending is increased to 2 percent of GDP by 2030—and assuming GDP trend growth—then spending will increase to €346bn in 2030, translating into 8.4 percent annualised growth. In the event that military spending is accelerated, which is quite likely, the growth rate will be double-digit in the coming years. As stated in Moretti et al 2021, expenditures for defence-related R&D represents by far the most important form of public subsidies for innovation and it causes spillover effects in privately funded R&D, resulting in overall productivity gains. While increased military spending is happening in Europe due to the horrific invasion in Ukraine, it could cause long-term economic growth and innovation in all of Europe.

As a result, we are positive on the defence industry as a theme and our defence theme basket represents 25 defence contractors in the US and Europe. These companies provide exposure to military spending and should be viewed as an inspirational list and not investment recommendation.

Name	Mkt Cap (USD mn.)	Sales growth (%)	EBIT margin (%)	Diff to PT (%)	5yr return
Raytheon Technologies Corp	145.733	13,8	7,7	9,6	66,3
Lockheed Martin Corp	117.801	2,5	13,6	0,6	88,2
Boeing Co/The	105.744	7,1	-4,7	44,0	7,5
Airbus SE	89.505	4,5	10,2	41,2	54,9
Northrop Grumman Corp	68.914	-3,1	15,8	-1,1	99,2
General Dynamics Corp	65.056	1,4	10,8	8,9	37,6
L3Harris Technologies Inc	48.265	-2,1	11,8	5,9	144,3
TransDigm Group Inc	34.728	2,9	37,5	18,1	220,4
BAE Systems PLC	29.523	1,3	11,5	-0,6	37,4
Thales SA	25.863	-4,7	7,4	9,3	34,5
Howmet Aerospace Inc	14.205	-5,5	15,0	17,7	52,8
Dassault Aviation SA	12.130	32,0	7,4	8,7	21,3
Rolls-Royce Holdings PLC	10.188	-3,9	4,2	33,1	-63,5
Elbit Systems Ltd	9.342	12,1	8,1	-19,4	86,8
Rheinmetall AG	7.331	2,4	9,3	10,3	132,0
Kongsberg Gruppen ASA	6.537	7,2	10,4	0,0	235,3
Leonardo SpA	5.717	5,4	5,7	12,2	-31,3
Saab AB	5.059	10,5	7,4	-9,4	12,0
Ultra Electronics Holdings PLC	2.976	0,0	13,9	-5,9	67,1
QinetiQ Group PLC	2.319	7,2	7,3	11,3	22,6
Babcock International Group PLC	2.236	0,2	-38,3	11,8	-57,8
Chemring Group PLC	1.236	-2,3	12,6	8,5	84,9
INVISIO AB	687	11,5	4,2	42,0	110,5
Avon Protection PLC	515	0,7	-11,7	12,4	44,6
Avio SpA	281	-17,7	1,1	35,0	-3,5
Aggregate / median values	**811.892**	**2,4**	**8,1**	**9,6**	**52,8**

Source: Bloomberg and Saxo Group

Saxo
Strats

Ole Hansen joined Saxo Bank in 2008 and has been Head of Commodity Strategy since 2010.

He focuses on delivering strategies and analyses of the global commodity markets defined by fundamentals, market sentiment and technical developments.

@Ole_S_hansen

War and sanctions turbocharging already tight commodity markets

Ole Hansen // Head of Commodity Strategy

The prospect for a long-lasting cycle of rising commodity prices that we first wrote about at the start of 2021 continues to unfold. During the past quarter, the war in Ukraine and sanctions against Russia helped turbocharge a sector that was already witnessing a tightening supply outlook. Before government handouts and central banks dumping rates to zero helped drive a post-pandemic overstimulation of the global economy, years of ample supply with steady prices had reduced investments towards new production, thereby leaving producers ill-prepared for the demand surge that followed.

With supply already tightening, the commodity sector was extremely ill-prepared when President Putin ordered the attack on Ukraine, thereby triggering a change in the market from worrying about tight supply to seeing supply disappear. With Russia, and to a certain extent Ukraine, being major suppliers of raw materials to the global economy, we have witnessed some historic moves with Russia's growing isolation and self-sanctioning by the international community cutting a major supply line of energy, metals and crops.

The Bloomberg Commodity Spot Index, already showing gains similar to 2021—the best year for commodity returns since 2000—will likely spend Q2 consolidating with a focus on four major potentially market-moving developments: 1) Russia's willingness to stop the war, thereby beginning the long road to normalising commodity supply chains; 2) China's slowing economic growth versus its ability to stimulate the world's biggest commodity-consuming economy; 3) the strength and speed of US rate hikes and their impact on inflation and growth; and finally 4) whether commodity prices, especially across the energy sector and to a certain extent industrial metals, have reached levels that will see demand destruction set in.

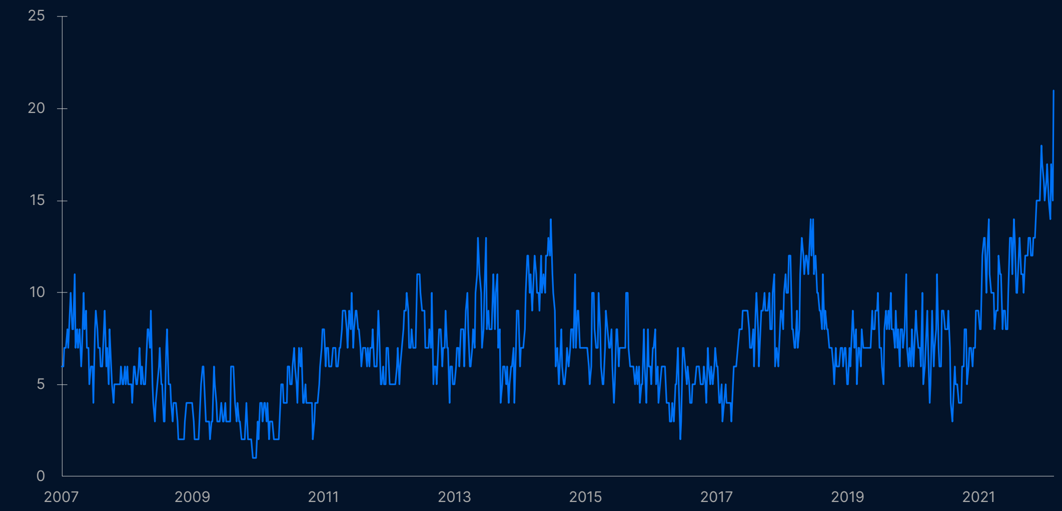
Bloomberg Commodity Spot Index

Sources: Bloomberg and Saxo Group

BCOM: One-year Roll Yield

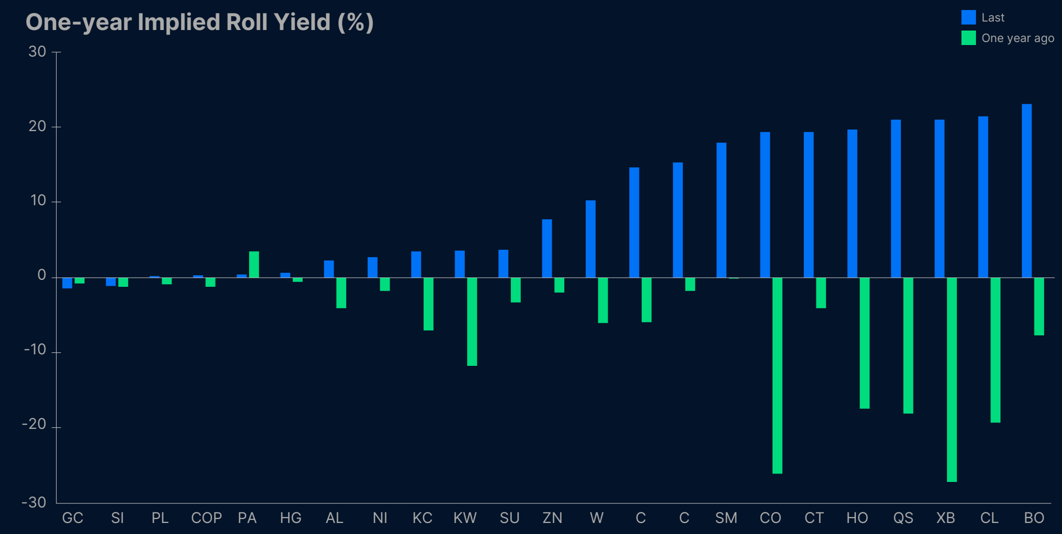
Sources: Bloomberg and Saxo Group

Commodities Trading in Backwardation



Sources: Bloomberg and Saxo Group *12 agriculture, 6 industrial metals, 4 precious metals & 5 energy

One-year Implied Roll Yield (%)



Sources: Bloomberg and Saxo Group

The tightening supply outlook that emerged across global commodity markets during the past year had already driven prices sharply higher before they were turbocharged by the sudden disruption of flows from Russia and Ukraine. As a result, the Bloomberg Commodity Spot Index—which tracks a basket of 24 major commodities spread evenly across energy, metals and agriculture—reached a record high on March 8, thereby recording a stunning and in the short term unsustainable year-to-date increase of 38 percent. A rally of such speed and magnitude lifting the input cost across the global economy carries the risk of slowing the growth and demand for many key commodities.

"With Russia, and to a certain extent Ukraine, being major suppliers of raw materials to the global economy, we have witnessed some historic moves

While most commodities—with a few exceptions—have since eased back towards their prevailing trends, the price-supporting tightness across markets has not yet shown any signs of easing. Measuring the spread between the first and second futures month we find that a record 21 out of 28 major commodity futures are currently trading in backwardation, a gauge which helps measure the market's concern about shortfalls and the higher price buyers are willing to pay for immediate delivery compared to delivery at a later date. Another measure shows the one-year roll yield on a weighted average of the components in the Bloomberg Commodity Index has reached a record 12 percent, with the strength currently being carried by the energy sector, cotton and grains.

Energy: Brent crude rallied to within a few percent of the 2008 record high after Russia invaded Ukraine, while fuel products, led by diesel, surged to fresh record highs. This was especially true in Europe where, as major buyers of Russian fuel products, self-sanctioning by several commodity traders raised concerns about the availability of supply. However, within a few days most of the gains had been given back with traders instead turning their attention to renewed Covid lockdowns in China and the US Federal Reserve beginning its long-awaited rate hike cycle.

With normal commodity supply channels from Russia broken, an end to the war in Ukraine is unlikely to trigger a swift return to normality. The breakdown in relations and trust between Putin's Russia and the West is likely to take a long time to mend.

Multiple uncertainties will trigger another wide trading range during the second quarter—potentially between $90 and $120 per barrel. Ultimately the market should stabilise with an upside price risk from reduced spare capacity among key producers and continued supply disruptions related to Russia being partly offset by slowing demand as the global economy becomes increasingly challenged by inflation and rising interest rates. Add to this a temporary Covid-related drop in demand from China and the outlook for a revisit to the March high looks unlikely.

Key events that could trigger additional uncertainty remain the prospect for an Iran nuclear deal, Venezuela being allowed to increase production and, not least, an increase US shale oil production, should producers manage to overcome current challenges related to lack of labour, fracking teams, rigs and sand.

For a technical outlook on Brent, please go to Kim Cramer's article.

Industrial metals: Aluminium, one of the most energy-intensive metals to produce, raced to a record high during March along with nickel, while copper reluctantly also briefly touched the highest level ever. Current supply disruptions from Russia will continue to support the sector throughout 2022, not least considering the ongoing push towards a decarbonised future. At the same time increased defence budgets in response to the Russian threat will keep demand robust despite the current risk of an economic slowdown. In addition, and supportive for the sector, is the outlook for slowing capacity growth in China as the government steps up its efforts to combat pollution, and ex-China producers for the same reasons being very reluctant to invest in new capacity.

While the energy transformation towards a less carbon-intensive future is expected to generate strong and rising demand for many key metals, the outlook for China is currently the major unknown, especially for copper where a sizable portion of Chinese demand relates to the property sector. But considering a weak pipeline of new mining supply we believe the current macro headwinds from China's property slowdown will moderate throughout 2022. In addition, we also need to consider the prospect that the PBOC and the government, as opposed to the US Federal Reserve, is likely to stimulate the economy, especially with a focus on green transformation initiatives that will require industrial metals.

While the Ukraine war and Russian sanctions turbocharged these metals to fresh record highs well ahead of expectations, the outlook for most metals remains supportive with tight supply and inelastic supply response likely to drive prices even higher throughout the rest of the year.

Precious metals: during the first weeks of 2022 the strength of gold surprised the market, not least because the January rally unfolded while US real yields moved sharply higher. The outbreak of hostilities in Ukraine then added a short-lived geopolitical risk premium which saw gold charge higher, only to miss the 2020 record high by a few dollars.

Heading into the second quarter we see gold eventually adjust to the US rate hike cycle and move higher. Our bullish outlook is based on the belief that inflation will remain elevated, with components such as rising input costs from commodities, wages and rentals not being lowered by rising interest rates. We believe gold is also increasingly being viewed as a hedge against the markets' currently optimistic view that central banks will be successful in bringing down inflation before slowing growth forces a rethink of the pace of rate hikes and the resulting terminal rate.

Having reached our $2000 per ounce target ahead of time we see the market consolidate its first quarter gains before eventually hitting a fresh record high during the second half as growth slows and inflation remains elevated.

For a technical outlook on gold, please go to Kim Cramer's article.

Agriculture: The UN FAO Global Food Price Index hit a record high in February before the Ukraine war made matters worse by raising the prospect of even tighter markets across key food commodities, from wheat and corn to edible oils. Adverse weather in 2021 has already reduced global stock levels of key food commodities from soybeans to palm oil and corn. In addition, surging fuel prices will not only drive increased demand for biofuels, but also raise the cost of production through higher diesel and fertiliser cost.

We see an elevated risk of high food price inflation with the focus being weather events and, not least, the duration of the Ukraine war; an extended period of fighting may limit production from Ukraine, a major global supplier of wheat. In its latest monthly report, the US Department of Agriculture lowered its estimates for exports from Russia and Ukraine by a combined 7 million tons to 52 million; this estimated reduction remains clouded in a high degree of uncertainty and could rise sharply in the event of a long, drawn-out war, thereby keeping prices elevated.

Kim Cramer Larsson started his career in 1996 as an equities trader focusing on the US and Asian markets with BG Bank, London. In 1997, Kim relocated to BG Bank, Copenhagen (BG Bank was acquired by Danske Bank in 2000) to the position of equities trader and portfolio manager.

Kim began using technical analysis as a trading tool from 1997. In 2005, Kim was promoted to the position of technical analyst in the FX & Fixed Income Research department at Danske Bank. In his current role, Larsson focuses on technical analysis of equities, equity indexes, forex pairs, and more for Saxo Bank. Larsson's views and analyses can be found on Saxo's News & Research hub as well as at Saxo's Academy where he hosts webinars focusing on chart analysis.

Technical Outlook: Gold, Oil and a remarkable multi-decade perspective on Equities

Kim Cramer Larsson // Technical Analyst

> Over the past 2 - 3 years, equity markets around the world have been building up massive divergences

Gold
After a few years with little interest in late 1990s and early 00s, gold initiated a long uptrend in 2002. It lasted almost 10 years, topping out just below $2,000 per troy ounce. The precious metal had then formed a bubble pattern that burst in 2011; this was followed by 5 years of bear market before buyers took control in 2016.

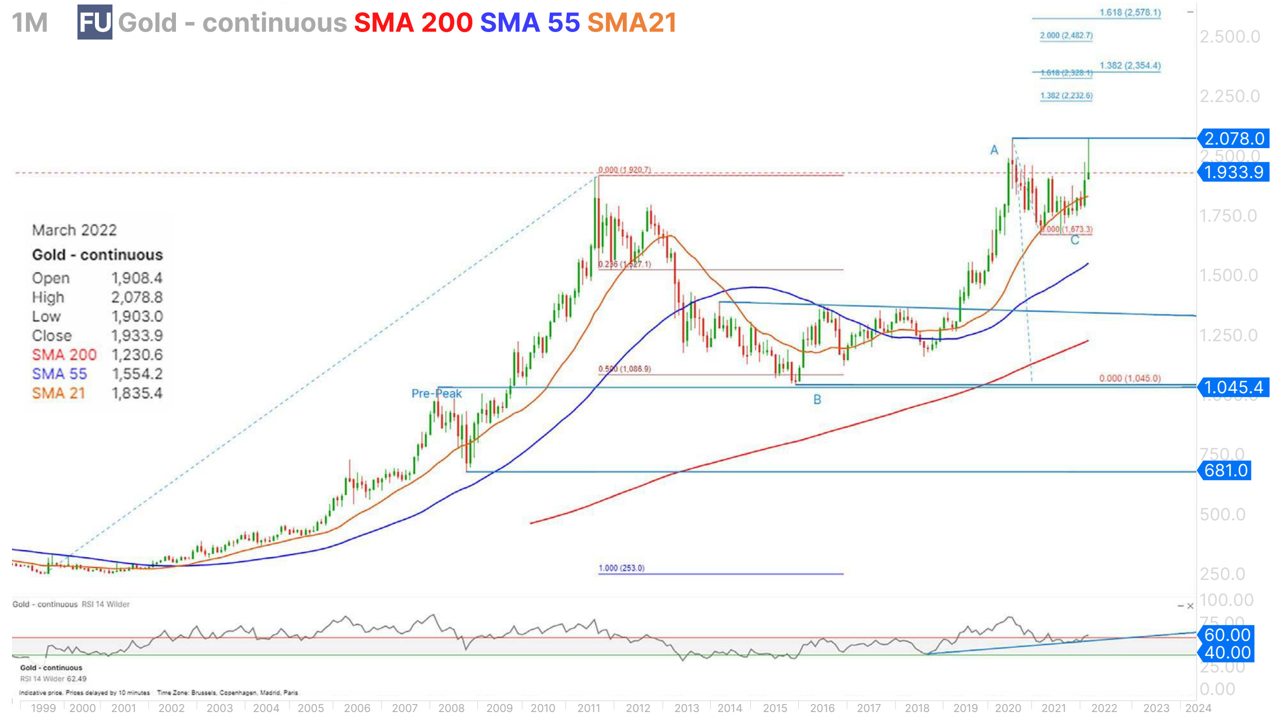
The rule of bubbles, and the implosion thereof, is that the instrument in question always comes down to at least the larger correction occurring during the uptrend, also called a pre-peak.

For gold this large correction—or pre-peak—occurred during the financial crisis in 2008-2009. Gold dropped to the peak of this correction/pre-peak level and the 0.50 Fibonacci retracement level (in other words, 50 percent of the bubble uptrend), just a few dollars above $1,000.

Slowly buyers came back to buy gold and made the precious metal form a rounded bottom, eventually taking it to new highs in 2020 when it peaked above the $2,000 mark. A short correction followed until the war in Ukraine resulted in renewed demand for gold with the shiny metal testing its all-time high. This got rejected but a new attempt seems likely.

Gold has formed what looks like a cup and handle pattern: B is the bottom of the cup and C is the handle.

The cup and handle pattern is confirmed if gold performs a daily close above peak A at $2,078. If this scenario plays out, we can then calculate possible targets. As a minimum gold should reach 1.618 projection of the handle height—in other words, a price target of around $2,328. Based on the full cup the price could potentially reach 1,618 projection of the distance between A and C—around $2,578. If demand deteriorates and gold breaks below $1,673 (the bottom of the handle), this cup and handle scenario is busted and a downtrend will unfold towards $1,500-1,350.



Source: Saxo Group

However, with the Relative Strength Index (RSI) showing no divergence and back above the 60 threshold, the bullish picture is supported.

Oil is in a bit of limbo these days after some panic moves higher followed by massive selling pressure.

Brent Crude oil broke above strong resistance at $126/brl shooting even higher to 1.382 Fibonacci extension of the third wave (that means when third wave is the length of 1, the fifth is the length of wave 3 × 1.382) in what looks like an exhaustive fifth wave.

However, when wave 5 is extended as it seems to be, it often extends to 1.618 times the length of the third wave—i.e., to around $148/brl. The all-time high recorded back in 2008 was $147.50.

At the time of writing Brent oil is back below resistance levels and trading in the consolidation area from 2012-2014—between $100 and $115. It seems like the uptrend is exhausted, at least on the face of it, but buying could resume.

Technically there is no divergence on RSI indicating we could see higher levels, possibly testing the all-time high around $147.50. However, if Brent closes below this month's low at $98.30 the selling pressure could push Brent lower towards 0.764 Fibonacci retracement of the fifth wave, at around $83/brl.

Source: Saxo Group

Dow Jones Industrial Average Index

Going back 40+ years the stock market has experienced periods of longer-running bull markets followed by almost as many larger corrections and even a couple of market crashes.

Examining these historic uptrends and corrections a bit closer we can see that in the build-up to every single larger correction there have been warning signs in the form of divergence in the market. Divergence is an indication of an imbalance and can been read from technical indicators such as RSI, MACD and volume. If price is rising under falling traded volume it is a sign of weakness. Similarly, it is a sign of a weakening trend if prices keep rising but the RSI is falling; that is exactly what we have seen in the run-up to market peaks and corrections.

As can be seen from the Dow Jones Industrial Average Equal Weight Index chart there was divergence up until the 1987 crash where Dow Jones lost 40 percent. There was also divergence during the dot com and housing bubbles.

Divergence—or imbalance—can run for a long time but must eventually be "traded out". That can be done when the RSI drops below the 40 threshold. When that occurs divergence is cancelled—or reset, so to speak. Over the past 2-3 years equity markets around the world have been building up massive divergences. Markets have been moving higher but RSI values have not achieved greater highs.

Granted we have seen larger corrections—most notably in 2020 when the Covid scare hit equities—but even that sell-off was not enough to push the monthly RSI below 40. The bull market that followed has just added to the imbalance in the market, building more divergence. However, now could be the time that divergence will be traded out. The FAANG/TINA (There IS No Alternative if you wanted a return on your money) bull run has run longer than the dot com bull market and has the longest-running divergence in the past 40 years.

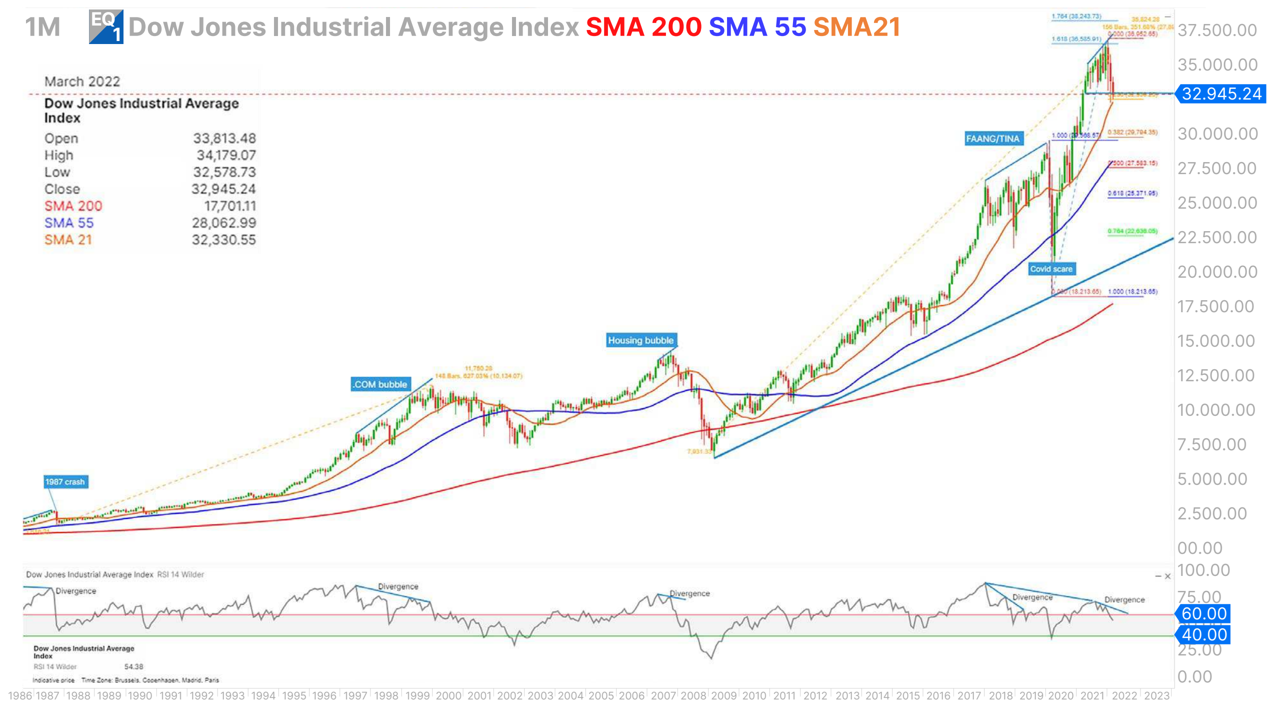
The strong bounce on the back of the Covid scare sell-off and continued bull run has reached 1.618 projection (of the Covid scare sell-off mini-crash), and seems to have exhausted. The downtrend is confirmed on both daily and weekly periods, and a monthly close below 32,985 will confirm the longer-term uptrend to be over.

Dow Jones is currently testing 0.236 Fibonacci retracement of the uptrend since the Covid low. Support is not strong around these levels and the Dow Jones could drop to the 0.382 retracement which coincides with the market peak before the Covid scare hit markets, at around 30,000.

However, a drop to 30,000 is not likely to push the RSI below 40—in other words, it won't unwind the divergence. And it will still be quite far away from its 55 Simple Moving Average (SMA). It is not unlikely the price and the SMA will catch up.

If the Dow Jones closes below the pre-Covid scare peak at 29,568, which is not unlikely, the bear trend could be further fuelled. If that scenario plays out the longer-term rising trend line could be tested with a drop to the 0.618 retracement at around 25,000.

For this likely scenario to be demolished and reversed, the Dow Jones needs to perform at new all-time highs.



Source: Saxo Group

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Althea Spinozzi joined Saxo Bank in 2017, and serves as Senior Fixed Income Strategist.

Althea produces Fixed Income research and works directly with clients in order to help them select and trade bonds. Because of her background in leveraged debt, she is particularly focused on high yield and corporate bonds with attractive risk and return.

@Altheaspinozzi

A painful path to normalisation

Althea Spinozzi // Senior Fixed Income Strategist

During the second quarter of the year, the bond market will continue to find itself between a rock and a hard place. While the Federal Reserve will actively engage in aggressive monetary policies to curb inflation, geopolitical concerns will add upward price pressures and fears of slower growth. Thus, volatility will remain elevated, causing more widening of credit spreads.

The most significant difference between the first and second quarters of 2022 is that while bond yields surged on monetary policy expectations at the beginning of the year, now markets need to consider what central banks will actually do. Policy decisions will not be confined only to interest rate hikes. They will touch upon other tools such as the runoff of their balance sheet, forward interest rate guidance and their economic outlook. If central banks disappoint market expectations, the risk of entrenched sustained inflation becomes higher; if central banks overtighten the economy, the risk of a recession increases.

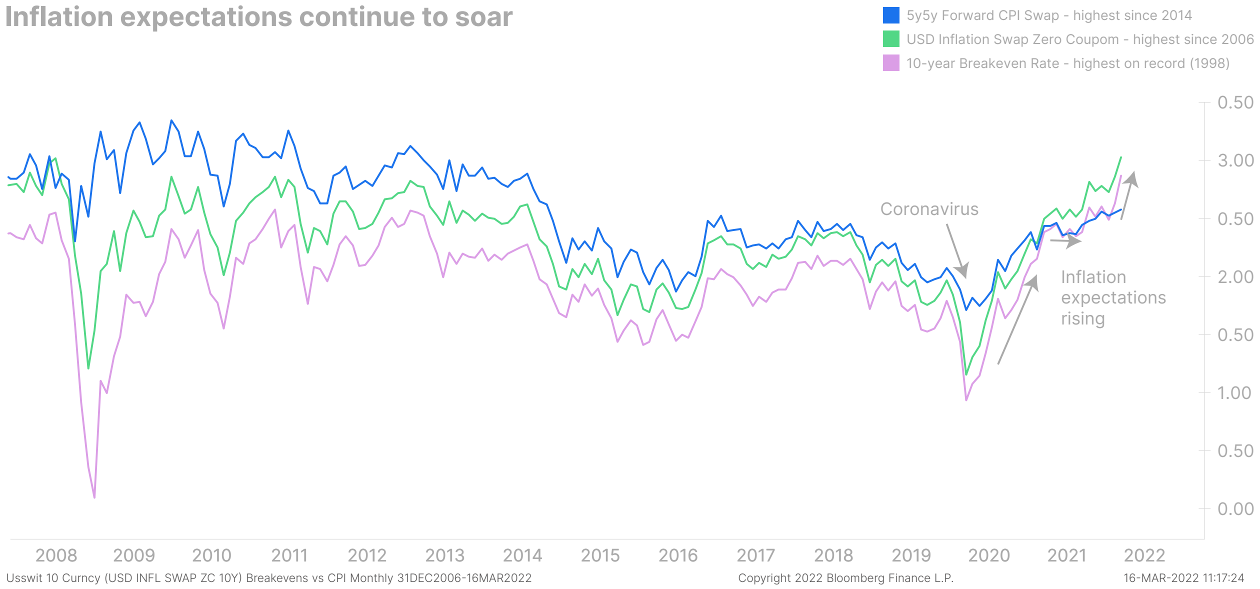
Whether you want to admit it or not, we have entered a bond bear market, where yields are destined to increase substantially. In this environment, traditional safe havens like US Treasuries will not protect investors looking to diversify portfolios. Duration will be even more toxic than at other times in history because we are starting off from record low interest rate levels and there is no higher income to fall back on. This is a result of years of accommodative monetary policies, which distorted risk perception and forced investors to take on more risk either through credit or duration.

Therefore, the chances for a tantrum in credit markets has increased. The good news is that following a dark period of uncertainty and volatility, a new and better equilibrium will be restored, enabling investors to rebuild their portfolios at much better market values.

The Federal Reserve will not stop until it has inflation under control

Since the beginning of the year, US Treasuries have suffered from the most significant losses compared to any year since 1974. Their weak performance is attributable to bets on interest rate hikes for 2022. However, the situation has recently become more complex. With the rise of geopolitical tensions, investors have been divided between high inflation and a slowdown in growth.

That is a massive headache for the Federal Reserve, which originally envisioned tightening the economy in an expansion as inflation was peaking. Right now, it's difficult to say when inflation will be peaking, while it's inevitable that the economy will slow down. The Federal Reserve needs to redirect its efforts to fix one of these two problems. We believe that it will work towards containing inflation at the cost of growth this time around. Indeed, inflation expectations in the US have recently soared to record new levels across the curve, showing that high inflation is becoming more entrenched than initially thought.



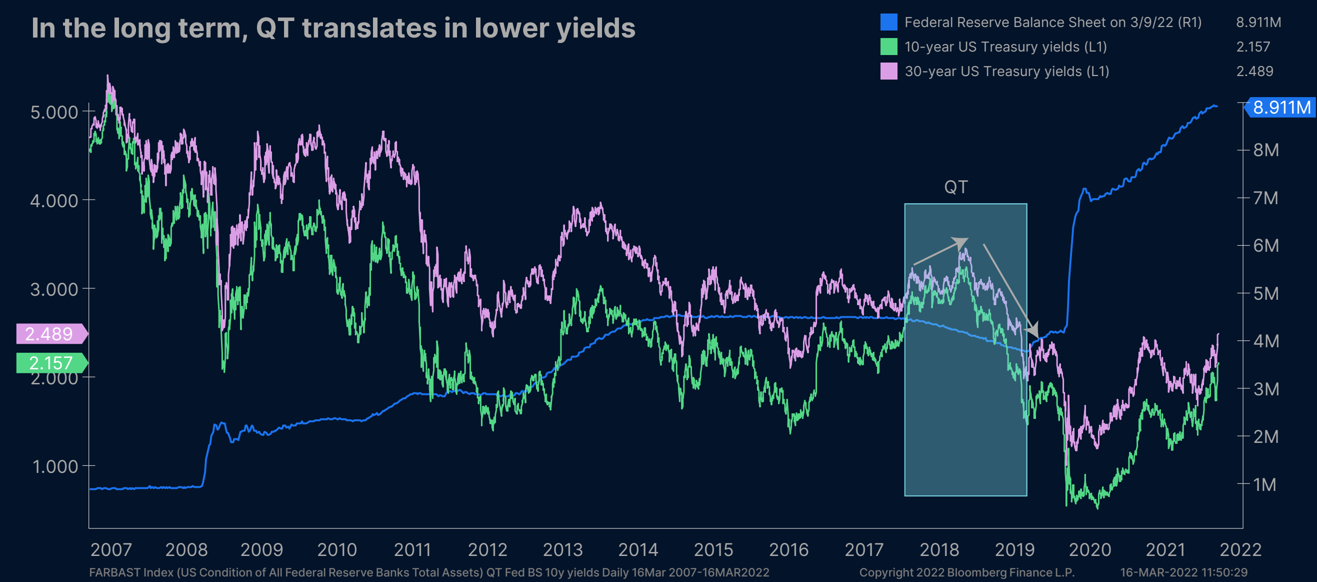
Source: Bloomberg and Saxo Group

However, fighting inflation is not as straightforward as one might think. Although a supply shock has produced the inflation we are experiencing now, the Federal Reserve only has the power to limit demand. Even so, it makes sense to intervene with higher interest rates to avoid inflation from rising further. However, higher rates need economic optimism, which is currently being eroded by uncertainties surrounding the energy crisis. Therefore, the strategy of the Fed to focus on interest rate hikes might provoke the yield curve to flatten further or even invert, flagging a recession in the near future.

That's why we believe that sooner rather than later, the Fed will need to begin with the runoff of its balance sheet to lift long-dated interest rates. However, it's critical to acknowledge that in the past, a balance sheet reduction has been synonymous with lower rates in the long term. The best example is the 2018-2019 quantitative tightening (QT): while long-term rates rose initially, as market volatility intensified yields dropped sharply.

History tells us that central banks are better at controlling the short part of the yield curve rather than the long part, as longer-term rates depend on investors' perception of whether the economy can withstand the Fed's tightening path. It won't be different this time around, and the Fed might need to provoke a recession to get hold of inflation.

Therefore, our projection is for US Treasury yields to rise across the yield curve in the mid-term, provoking a mild flattening of the yield curve. However, long-term yields might begin to adjust lower not far from the beginning of QT, causing a sudden flattening or even an inversion of the yield curve.



Source: Bloomberg and Saxo Group

European bond yields will continue to soar, and sovereign spreads will widen

In Europe, things are going to get worse before they get better. The energy crisis is putting substantial upward pressure on inflation. Thus, the ECB will not maintain an accommodative stance and will be forced to end stimulus early to begin to hike interest rates as soon as September this year. The ECB is running the risk that if it stays way behind the curve compared to the Federal Reserve, the euro currency might devalue further, bringing even more inflation.

In the meantime, European countries will look to finance their defence and energy spending by increasing their government bond issuance, adding upward pressure on yields. The big problem is that this time around, the ECB will not be there to digest countries' debt binge as it did in the wake of the Covid pandemic. Therefore, volatility in the rates market will soar. It will not be unrealistic to see 10-year Bund yields rising to hit our 0.6 percent target while European government spreads widen considerably.

“The bond market will continue to find itself between a rock and a hard place

Besides being politically problematic, a substantial widening of sovereign spreads is also a problem for the central bank's tightening agenda as financial conditions will tighten faster in certain countries than others. We believe that the ECB will tolerate such widening until the BPT-Bund spread hits 250bps. At that point, the central bank might need to decide whether to prioritise inflation or growth.

Fiscal policies at the EU level might help against a fast widening of sovereign spreads. All EU members share the same energy and defence spending issues, so an EU defence and energy package financed through the issuance of EU joint debt makes sense; it will limit volatility in the European sovereign space, allowing the ECB to focus on inflation. However, as we have learned during the Covid-19 pandemic, it might take a long time for EU members to reach an agreement, so it's unlikely that the periphery will benefit from such support during the year's second quarter.

European sovereign spreads will resume their widening

As the BTP/Bund spread hits 250bps the ECB will need to chose between inflation or another European sovereign crisis

Source: Bloomberg and Saxo Group

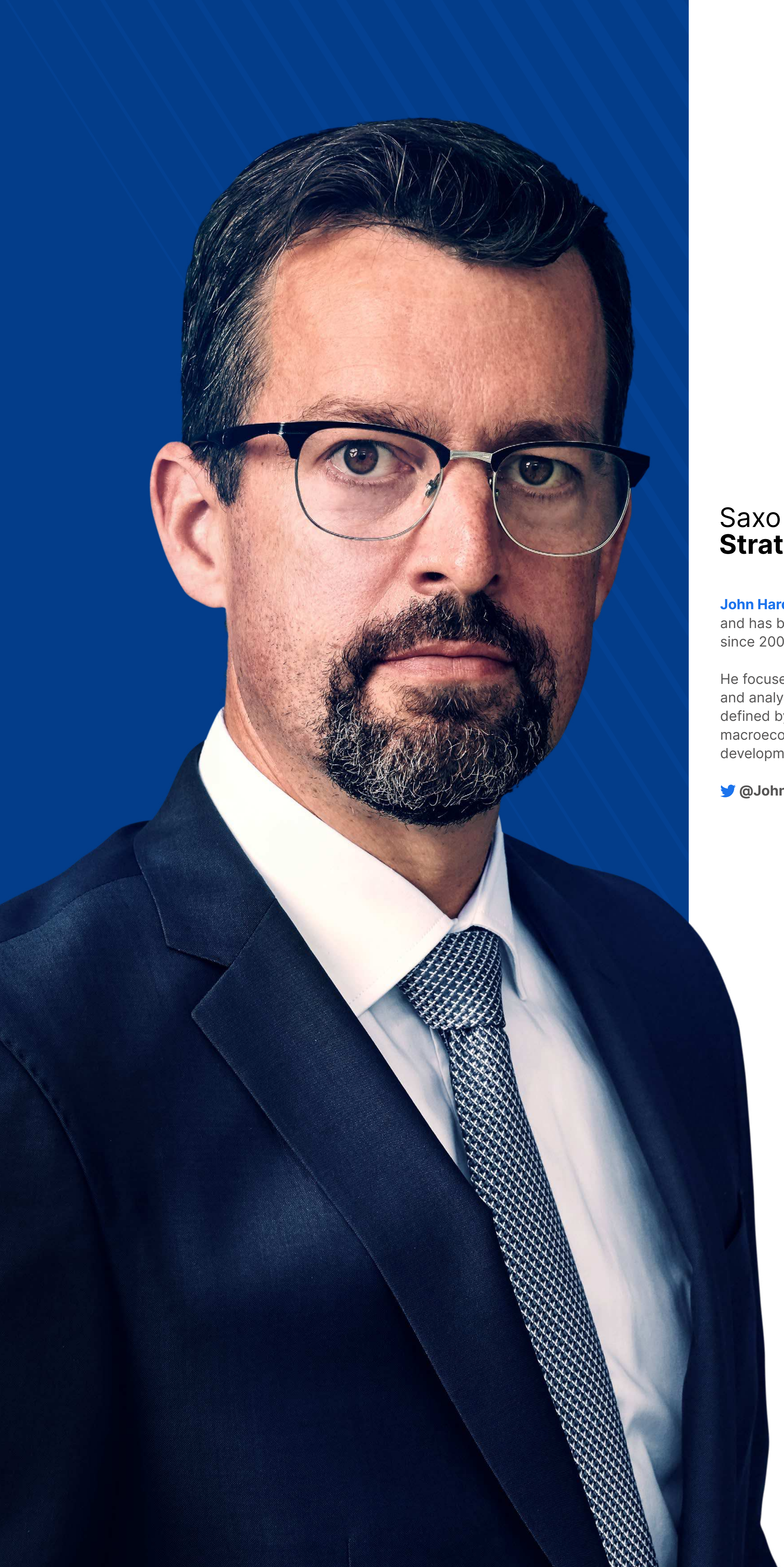
Corporate bonds are under more stress

It's unlikely that the widening of corporate bond spreads has ended. As central banks worldwide begin to hike rates real yields will increase, tightening financial conditions further. Even with deeply negative real yields, we are starting to see several red flags coming from the corporate bond space: widening spreads, choppy primary markets and loss of risk appetite from investors.

As volatility remains sustained, weaker companies will find it more difficult to access the primary bond market, increasing refinancing risk and the risk for a tantrum.

Corporate bond yields soared to the highest since the Covid Pandemic

Source: Bloomberg and Saxo Group



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John Hardy joined Saxo Bank in 2002 and has been Head of FX Strategy since 2007.

He focuses on delivering strategies and analyses in the currency market as defined by fundamentals, changes in macroeconomic themes, and technical developments.

@Johnjhardy

FX: The great EUR recovery and the difficulty of trading it

John Hardy // Head of FX Strategy

The Russian invasion of Ukraine took the euro down just after the currency had begun mounting a significant recovery attempt in anticipation of a shift toward tightening from the ECB at its March 10 meeting. The ECB did make a reasonably hawkish shift given the uncertain backdrop, but more important still has been Germany—within days of the Ukraine invasion—promising massive fiscal outlays to address its energy and defence vulnerabilities. The EU has joined the call and will fund large new fiscal initiatives with joint debt issuance. All of these fiscal moves will profoundly deepen EU capital markets and could provide a long-term boost for the euro. If the terrible fog of war hopefully lifts soon, the conditions are promising for the euro to reprice significantly higher.

Euro: the fog of war versus the promise of domestic investment and ECB tightening.

It is important when studying markets to always consider what is "in the price", or what the market is expecting to happen in the coming six to twelve months rather than the current lie of the land. This is particularly important as we are on the cusp of an expected significant monetary policy tightening in the US and elsewhere. The outlook for the ECB is directionally similar, but less certain. That is largely because the eurozone and its periphery are the economic areas most beset with uncertainty and direct exposures from any further fallout from the war in Ukraine. The situation can change dramatically from the time this is being written, either for the better (détente/peace) or for the worse (a complete severance of energy deliveries from Russia). That should mean that the potential range of euro outcomes is extremely wide over the next one or two quarters. But already baked into the cake is a profound support for the euro: a massive new fiscal programme led by Germany, which is promising approximately 5 percent of GDP in new spending to address energy, defence and other vulnerabilities made painfully evident by Russia's invasion of Ukraine.

The most supportive combination for a currency is tighter monetary policy and looser fiscal policy, and the eurozone is set to move the most in the fiscal direction over the coming year at least. The ECB monetary policy can play some reasonable catch-up once the war in Ukraine hopefully disappears as a factor, even if difficult relations with Russia—and a cloud over its energy exports into Europe—could remain. The ECB signalled a far more rapid quantitative tightening schedule at its March meeting than was expected and is clearly ready to hike as soon as it has stopped expanding its balance sheet by Q3. We could be headed to a positive ECB policy rate by year-end if the war in Ukraine has ended by then. And to emphasise the fiscal policy differentials with elsewhere, let's compare the new EU fiscal largess with an outright fiscal cliff in the US. Fiscal outlays are likely frozen because of political gridlock within the Democratic party and are unlikely to improve after the mid-term elections, which is likely to put one or both parties of Congress under Republican control. So, while a major further downdraft in the euro is certainly possible in the coming quarter if the impact we saw in the first two weeks of the war in Ukraine returns and deepens, the fundamentals for the euro have shifted profoundly to the positive. EU existential risks have receded decisively as Russia's aggression has sparked deepening fiscal integration. The new EU and especially German fiscal outlays will deepen EU capital markets, keeping more capital at home rather than recycled abroad. The euro is primed for a strong comeback if the fog of war lifts soon.

Chart: looking up for the euro? The euro has been weaker than it was shortly after the Russian invasion of Ukraine this year on only two occasions since the early 2000s—and the EU sovereign debt crisis of 2010-12 was surprisingly not one of those times! Rather, the first time was the episode starting in 2015 when there was remarkable policy divergence between a tightening Fed and the Draghi ECB finally rolling out its tardy QE policy. Then there was the brief new low at the pandemic outbreak. From here, we are far more constructive on the euro's potential, especially from the angle of fiscal policy divergence. The EU is moving aggressively on the fiscal front with new spending priorities on energy and defence sparked by Russia's invasion of Ukraine, while a considerable fiscal drag is set to deepen for the US and the UK, for example. The chart is of the JP Morgan real effective, CPI-adjusted Euro.

Source: Bloomberg

USD: The end of reserve status and all that.

Many suggest that the coordinated sanctions against Russia's central bank assets in the wake of its invasion of Ukraine are a once-in-a-generation historic development, perhaps on a par with Nixon's closing of the "gold window" that effectively ended the Bretton Woods system in 1971. Certainly, any nation that accumulates significant reserves and thinks that it could risk falling foul of Western alliances will find it unacceptable that its financial system and economy could prove as vulnerable as Russia's.

China in particular, as the world's largest holder of foreign reserves and in increasing rivalry with the US, will likely see the actions against Russia's central bank as a massive wake-up call that will make it want to move as quickly as possible away from reliance on the US dollar. On top of that, with the explosion of commodity prices and the lack of US fiscal discipline, any major holders of USD and other fiat FX reserves may want to diversify out of holding negative-yielding fiat assets and invest in commodities and other hard assets and productive capacity instead, even if there is no immediate sanctions threat.

These processes take time, and the US dollar will retain a premium as the world's most liquid currency as we navigate the rocky road ahead. Markets will need to get accustomed to higher inflation and far tighter monetary policy, but the US dollar is set for a major reset lower in the years ahead as major exporting countries will not find it a store of value. They will look to recycle their surpluses elsewhere, making it increasingly difficult for the US to fund its yawning twin deficits.

The "G10 smalls": the rocky ride set to continue on commodity and sentiment volatility

Q1 saw the five small G10 currencies—the three commodity dollars (AUD, CAD and NZD) and the Scandies (NOK and SEK)—trading with perhaps an historic degree of performance divergence. The Swedish krona, for example, was doubly weak on the combination of its traditional sensitivity to risk sentiment, along with its economy being seen as leveraged to the outlook for the wider EU economy, which received an ugly blow from the war in Ukraine. The more commodity-leveraged AUD soared as Australia's commodity export portfolio is almost a perfect offset for the war in Ukraine, given that it's a major wheat exporter and the world's largest exporter of LNG. NOK got a boost from oil prices, CAD less so, and somehow NZD enjoyed a tailwind as a major food-secure exporter and after the RBNZ refreshed its hawkish stance from last year. SEK has since rebounded sharply and should do well on the positive backdrop for the euro, although it is sensitive to risky asset volatility. The oil currencies may be in for a rough ride later this year if recession looms on the damage that high energy prices have meted out. AUD is still one to watch for longer-term upside potential if China makes good on stimulus.

GBP: less in the cold, but fiscal picture a drag.

The Bank of England has moved to normalise policy before the Fed and certainly before the ECB, but is unlikely to match the pace of Fed hikes. The UK is more likely than some of its peers to be headed toward a recession this year on the combination of the impact of significant supply constraints in the economy, the energy spike, and a major fiscal drag, especially relative to the EU, which is set to move aggressively in the direction of expansion. EURGBP is worth watching as an important barometer for sterling. One offset on the positive side for sterling is that the EU's security vulnerabilities made clear by Russia's invasion of Ukraine will likely keep Brexit-related trade tensions at a minimum as the UK has the most potent military force in Western Europe and is needed as an ally.

JPY and CHF: birds of a feather only when yields are the focus. End of Japan's financial year!

Last quarter I was far too early in calling for mean reversion for the Japanese yen. It only got a minor bump from cratering risk sentiment in the outbreak phase of the war in Ukraine before it weakened to new historic lows, partly on soaring commodity prices due to the scale of Japan's reliance on food and energy imports, and later more on the backdrop of rising rates. During Q1, the Bank of Japan doubled down on its yield curve control (YCC) policy, defending the 0.25 percent cap on 10-year Japanese government bonds. Rising long safe haven yields theoretically mean that if global yields continue to rise, the yen will have to absorb the pressure if JGB's can't. However, the JPY is at historically cheap levels, and as we head toward a recession, the rise in long yields and commodities may moderate. The end of the financial year in Japan on March 31 is often also a critical pivot point—as it was in 2021, when the JPY bottomed and US yields peaked for the cycle on that very date.

As for the Swiss franc, its run-up on Russia's invasion of Ukraine was quickly reversed when Switzerland joined the international community in its sanctions against Russia, a further erosion of Switzerland's traditional special status as a safe harbour for money of possibly questionable origin. Rising yields are also a relative CHF-negative as the SNB will always pursue last-mover status, even if the country is still rock solid from a current account and stability angle.

EM currencies and CNH. As noted above, China will likely seek to move away from its reliance on the US dollar and other foreign FX with all possible haste. That is a difficult task to accomplish when the country operates with a capital controls regime domestically (the CNY is not tradeable off shore). There are technical workarounds—the offshore CNH with promises of perhaps physical settlement in something else such as gold or a digital currency—but it takes time to build trust in new arrangements, so how it achieves this goal bears close watching from here. Since early last year, China has already maintained a strong yuan policy as it has moved to deleverage the property sector and reduce the influence of the tech sector, and as a bulwark against rising commodity prices. These priorities are unlikely to change as long as commodity prices remain high, but the pace of CNH strengthening has become very steep this year and will threaten China's export competitiveness. China has also indicated easing priorities to support its flagging domestic economy, which continues to be disrupted by Covid-related lockdowns, a non-factor in most countries now. Elsewhere, there has been a clear commodity and current account angle to the development in EM exchange rates, which is likely to persist as long as commodity volatility remains high. Turkey and India are vulnerable on commodity exposure, while South Africa and Brazil have benefitted from their commodity exposure.

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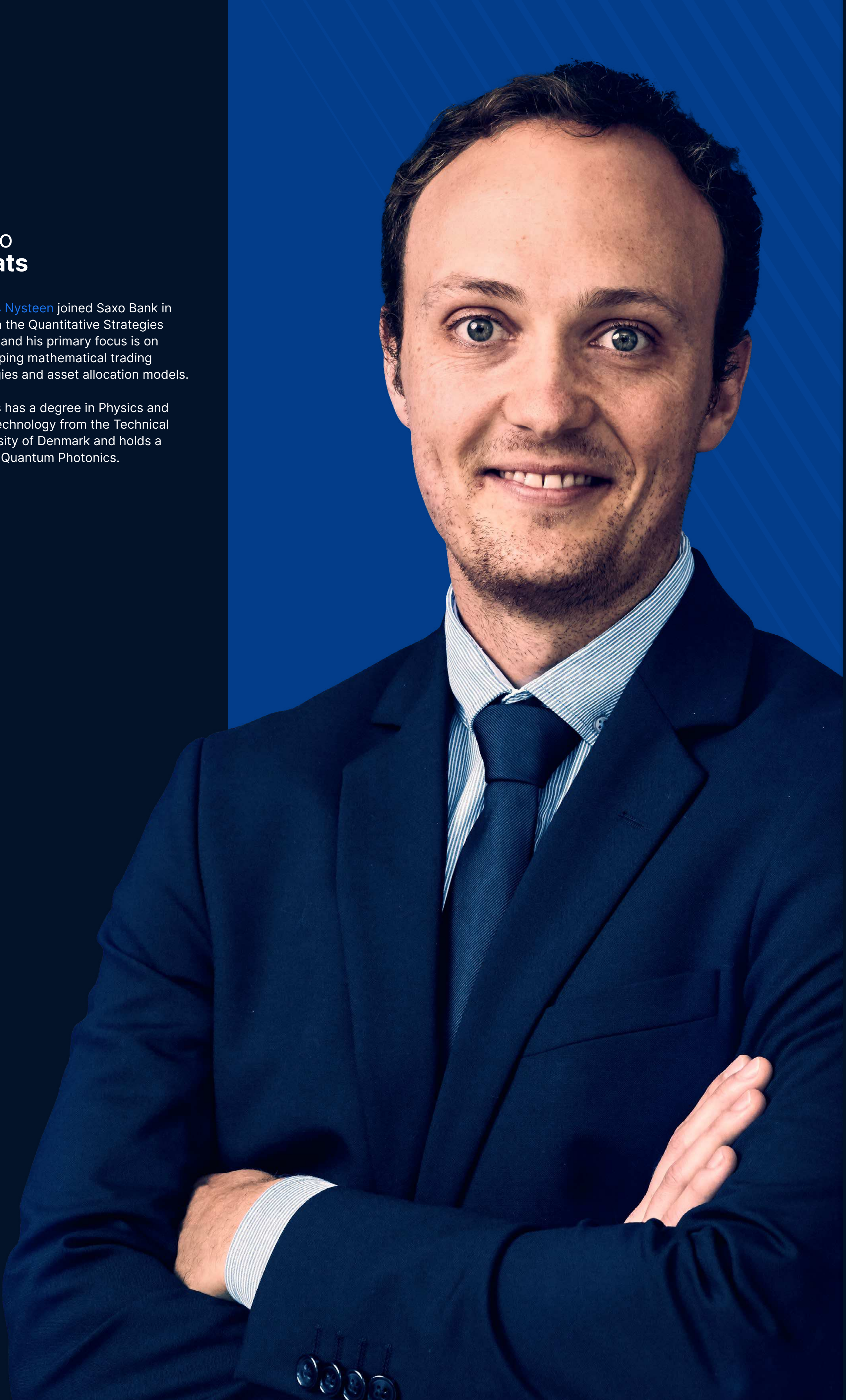
Anders Nysteen joined Saxo Bank in 2016 in the Quantitative Strategies group, and his primary focus is on developing mathematical trading strategies and asset allocation models.

Anders has a degree in Physics and Nanotechnology from the Technical University of Denmark and holds a PhD in Quantum Photonics.



Cybersecurity – The rush to catch up with reality

Anders Nysteen // Senior Quantitative Analyst

Cyberattacks continue to become even more hideous and sophisticated, and due to the closely connected global digital infrastructure, spillover effects may likely cause damage to places other than the intended target of a cyberattack. The invasion of Ukraine was a major wake-up call globally for both governments and private companies who are rushing to bolster their cyber defences.

> The invasion of Ukraine was a major wake-up call globally for both governments and private companies who are rushing to bolster their cyber defenses

In the weeks prior to the invasion of Ukraine, the country was hit by multiple cyberattacks. On February 15, major websites of the defence ministry, army and two of Ukraine's largest banks were down. A more severe attack on February 23 also took down multiple government websites, as well as placing data-wiping malware on computers belonging to multiple Ukrainian organisations. And after the invasion began, the number of cyberattacks over the following 48 hours increased by more than 800 percent.

Following a request from Ukraine, EU sent its Cyber Rapid Response Team to assist. The intention is of course to assist Ukraine in securing critical infrastructure, but it's likely also aimed at avoiding spillover effects to the global digital infrastructure. As we saw in June 2017 with one of the most severe global cyberattacks, NotPetya, a well-organised cyberattack can do extensive financial damage. The attack was primarily targeting Ukraine with around 80 percent of its hits targeting ministries, banks and transportation infrastructure. Large logistics companies such as Maersk and FedEx were also affected, and the estimated revenue loss was $200-$300m and $400m, respectively.

Governments call for cyber defense boost

The invasion of Ukraine was a wake-up call for nations to reinforce their cyber defences, especially within their critical infrastructure such as transportation networks, the health care system and important supply lines. In many countries the majority of the critical infrastructure is owned by private companies, which do not always meet the required standards for cyber defence. One notable infrastructure cyberattack was against the largest fuel pipeline in the US, the Colonial Pipeline; all pipeline operations had to be halted to contain the attack.

Because of the invasion, governments have called on organisations to bolster their cyber defences against online attacks, with Britain's National Cyber Security Center and the US Cybersecurity & Infrastructure Security Agency as examples. The latter is stating that "while there aren't any specific, credible, cyber threats to the US, we encourage all organisations—regardless of size—to take steps now to improve their cybersecurity and safeguard their critical assets." The US Senate also followed this by passing a bill requiring critical infrastructure operators and federal agencies to report cyberattacks within 72 hours and ransomware payments within 24 hours.

Cybersecurity industry growing rapidly

The volume and complexity of global cyberattacks were already growing prior to the invasion. According to a report by Coro, the number of cyberattacks against small-to-medium businesses has increased by 150 percent over the past two years, and the companies' defences have not grown accordingly. One issue is a shortage in workforce, which needs to grow by 65 percent for organisations to be able to sufficiently defend their critical assets, according to research among cybersecurity professionals by (ISC)2.

The cybersecurity industry is a rapidly growing industry and in Saxo Bank we monitor trends in the cybersecurity market through one of our thematic baskets. The theme basket contains 25 of the largest cybersecurity companies which are involved in creating, implementing and managing security protocols, in applications ranging from mobile phones to large-scale IT infrastructure; see the table on the next page. Over the past couple of years, the companies have in general had large revenue growth rates, as shown in the figure below. However, more than half of the companies reported a negative operating margin every year, measured over 12-month trailing figures. The cybersecurity industry is clearly an industry where growth has been prioritised over profitability, and it is undergoing a rapid consolidation with many of major cybersecurity companies acquiring smaller players. This is expected to improve profitability over time.

The evolution in global digitalisation demands an equivalent increase in cyber protection, and with the growing volume and complexity of cyberattacks, we expect the cybersecurity industry to continue to show high growth numbers relative to the general equity market.

Source: Bloomberg and Saxo Group

Name	Market Cap (USD mn.)	Sales growth (%)	Operating margin (%)
Palo Alto Networks Inc	53.775	28,4	-6,7
Fortinet Inc	44.888	28,8	19,5
Crowdstrike Holdings Inc	43.698	66,0	-9,8
Cloudflare Inc	28.752	52,3	-19,5
Zscaler Inc	28.378	60,4	-31,4
Okta Inc	24.141	55,6	-59,0
VeriSign Inc	22.492	4,9	65,3
Splunk Inc	19.399	19,9	-42,9
Check Point Software Technologies Ltd	17.816	4,9	41,9
NortonLifeLock Inc	16.082	10,4	41,5
F5 Inc	11.809	10,8	14,6
SentinelOne Inc	8.784	100,2	-124,1
Avast PLC	8.678	5,4	41,9
Trend Micro Inc/Japan	8.129	9,4	22,9
CyberArk Software Ltd	6.019	8,3	-15,6
Rapid7 Inc	5.954	30,1	-22,4
Tenable Holdings Inc	5.721	22,9	-7,7
Qualys Inc	4.975	13,3	21,3
Varonis Systems Inc	4.343	33,3	-25,3
Sailpoint Technologies Holdings Inc	4.108	20,2	-13,5
Darktrace PLC	4.093	48,2	-7,2
Venustech Group Inc	3.337	45,8	17,2
CommVault Systems Inc	2.692	8,3	5,4
Radware Ltd	1.470	14,6	6,4
F-Secure Oyj	859	7,3	7,5
Aggregate / median	**359.491**	**20,2**	**-6,7**

Source: Bloomberg and Saxo Group, data from 14 Mar 2022.

Sales and EPS growth is measured on 12-month trailing figures.

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Jessica Amir joined Saxo with 14 years of experience in financial markets and equities. She joined from Bell Financial Group, a stock broking business listed on the ASX, where she was the lead Senior Market Analyst and presenter. She previously headed news and content at the Sequoia group, which owns Finance News Network. Jessica also has extensive TV broadcast experience with ABC, Sky News, Seven Network and Nine Network - where she interviewed Prime Ministers including Tony Abbott, Julia Gillard and Kevin Rudd as well as Federal Treasurers and ASX 200 CEOs. Amir is a qualified financial adviser, and held roles at Commonwealth Bank, Suncorp and AMP.

@JessicaDAmir

Australian investing: Six considerations amid triple Rs: rising rates, record inflation and likely recession

Jessica Amir // Market Strategist

Australia's national export income and stock market will likely be jolted higher in Q2 and for the rest of the year, with the luckily commodity-rich country tipped to come out on top while the world braces for the big three Rs: record inflation, rising interest rates and a possible recession.

“ As the Australian Federal Election campaigns ramp up, the coin jar for commodity and green energy spending will also be jingling

Australia's stock market outperformed global equities in Q1 as its coal, LNG, iron ore, gold and agricultural equities flew off to the races. We think momentum will continue in Q2 with mining and agricultural stocks primed to strengthen amid higher prices and accommodative China policy. As the Australian Federal Election campaigns ramp up, the coin jar for commodity and green energy spending will also be jingling. Here are 6 considerations for the quarter.

Consideration 1 – at a national level, foreign investors will increasingly be compelled to invest in Australia
This supports the Australian dollar. Australia boasts one of the highest trade surpluses (exports minus imports) in the G20 countries—meaning it earns more money. It's also likely to have one of the strongest economic growth rates in the G20 (4.3 percent GDP) and one of the best employment rates (just 4 percent unemployment this year and 3.9 percent next year). This is all thanks to Australia being the king/queen of exports. It is:

- the world's largest iron ore mining country;
- the second-biggest LNG exporter;
- the third-biggest uranium producer;
- the fourth-biggest coal nation;
- the fifth-biggest copper and lithium producer;
- the sixth-biggest wheat and other grains exporter.

Australia is benefiting from commodity prices surging. The iron ore price is up 28 percent so far this year, oil is also up 36 percent and wheat is up 41 percent (as at March 29). Australia's exports surged to AUD 49.3 billion in January (the most recent reading), so you can bet that Australian exports will climb further in March. On top of this, prices are poised to rise over the longer term, amid anaemic supply and roaring demand, further benefiting Australia; this will attract more foreign money.

Consideration 2 - higher commodity prices to benefit the ASX, but specifically the commodity sector, which makes up 30 percent of the Australian share market

BHP (BHP), the world's biggest miner, is an AUD 171 billion company—it's the biggest company on the ASX. **Rio Tinto (RIO)**, the world's second-biggest miner, is an AUD 120 billion company—the third-biggest stock on the ASX. **Fortescue Metals (FMG)** is also in the mix. These stocks are poised to pay the highest dividend yields in the world; BHP with 10.5 percent yield, Rio 10 percent and Fortescue 16.4 percent. Their above-market dividend yields attract large institutional investors and retirees seeking income stability in a very noisy and volatile market. Additionally, shareholders also stand to benefit from share price growth as the iron ore price rallies. Remember earnings and cashflow growth drives share price growth.

The iron ore price is about AUD 150 at the time of writing. It's likely to move north this quarter for three reasons: China has relaxed its carbon emissions targets for five years, meaning it can produce more steel; China dropped its official interest rates three times, encouraging property firms to borrow money and buy iron ore for steel; and China wants to ramp up economic activity to achieve its growth target of 5.5 percent in 2022. So you could expect higher highs for BHP, Rio and FMG shares as earnings growth slowly improves. However, there are risks to be considered, the biggest being if China ceases or reduces Australian trade; based on our discussions with BHP, we don't think this is likely. Considering that these three companies generate a combined AUD 96 billion in total revenue from China, Australia wouldn't want to fray that tie.

Note: In 2021 BHP made 66 percent of its revenue from China; that figure was 57 percent for Rio and 89 percent for FMG. When China's economy grows and it boosts infrastructure spending these companies grow too and—given their sheer size of the market—the ASX gets a boost.

Consideration 3 – Australia's federal election is in May

More fiscal commodity sector spending will likely be announced so that Australia can achieve carbon neutrality by 2050, so watch commodity stocks and ETFs. Australia has some of the largest rare earth reserves in the world, and wants to compete with China in supplying the 17 rare earth elements to the high-tech manufacturing sector. China supplies 70 to 80 percent of global rare earth industry needs. In March, the Australian prime minster pledged AUD 243 million to four Australian rare earth projects, including a new nickel manganese cobalt battery material refinery hub and a vanadium refinery project led by Australian Vanadium. In September 2021, Australia's government announced a AUD 2 billion loan facility to help secure Australian critical minerals projects. The announcements supported rare earth stocks and ETFs higher; given global undersupply and rising high tech demands, support is likely to continue. The ASX's biggest rare earth company, **Lynas Rare Earths (LYC)** is a great example—the market thinks it could see 102 percent revenue growth this year with earnings growing by 71 percent; that could be worth a look. Alternatively, consider looking at an ETF in rare earths, like the **VanEck Vectors Rare Earth/Strategic Metals ETF** that invests in 22 rare earth and strategic metal stocks across the globe.

Consideration 4 – remember a company is valued on future cashflows and earnings

The biggest earnings, cashflow and sales growth are tipped to come from the energy sector this year, with over 60 percent earnings per share growth likely—it's hard to walk past. I like to pick companies that are growing their market share and earnings in the industry. **Whitehaven Coal (WHC)** and **Woodside (WPL)** are great examples, with both being leaders in their fields and tipped to see rising demand, benefitting from higher long-term underlying commodities prices which support their share growing. Both companies' shares are up 50 percent in Q1 and they operate on low price-to-earnings ratios, meaning they are 'cheaper' to buy in comparison to the 'earnings' they generate. These are just examples.

Consideration 5 - consider selling out of listed property and consumer discretionary spending stocks

It's not just the cost of chicken, beef, oil and bread that are rising—so too is lumber. It's flowing to builders, squeezing their profits, while higher house and construction prices are being passed to consumers; this has started to cause cracks in the property market. This has big knock-on effects, and this is before interest rate rises have even begun. In Q1, ASX-listed property stocks have collectively fallen 8 percent and ASX consumer discretionary spending stocks are down 12 percent (at the time of writing). More losses are expected in Q2 and Q3. Why? Australia's debt-to-income ratio climbed to 185 percent. After an expected rate rise in May, mortgage repayments will rise and cost of living will go up, resulting in decreased consumption and a slowdown in property demand.

Consideration 6 - consider softer agricultural commodities too

Consider not only have having a bigger chunk of your portfolio in hard commodities such as metals and energy, which will benefit from higher prices this quarter, but also in softer agricultural commodities—they are also poised to benefit from the supply glut and continued rise in demand. Meat, grain and fertiliser business **Elders (ELD)** is a great for example of a company to look at. They're able to benefit from higher prices and higher profits this year. Australian grain giant **GrainCorp (GNC)** is another example; they are also tipped to reap higher earnings and profit growth. And don't forget that commodities need to be shipped all around the world, so consider looking at global freight and logistics companies—great examples are **Qube (QUB)** and **WiseTech (WTC)**.

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Christopher Dembik joined Saxo Bank in 2014 and has been the Head of Macro Analysis since 2016.

He focuses on delivering analysis of monetary policies and macroeconomic developments globally as defined by fundamentals, market sentiment and technical analysis.

@Dembik_Chris

The Great **Erosion**

Christopher Dembik // Head of Macro Analysis

Inflation is anything but transitory. At its March meeting, the European Central Bank (ECB) released its latest staff macroeconomic projections. In all scenarios, the euro area Consumer Price Index (CPI) is expected to decrease close to 2 percent year on year in 2023 (see Chart 1). This is wishful thinking; it currently stands at 5.8 percent year on year (the latest figure for February). It's not just oil and energy prices that are rising fast anymore. Food, non-energy industrial goods and services are all accelerating at more than 2 percent; inflation is now broad-based. This is before we see the full consequences of the Ukraine war on the inflation dynamics. Our baseline is that the war will add at least one percentage point to the average euro area CPI this year. We have discovered with the conflict that Ukraine is a hub of international trade; for instance, it produces 70 percent of global neon gas exports. This purified version of gas is crucial to the semiconductor industry and we need it for many daily life products such as smartphones, medical devices and household appliances. But war is not the only issue on the table.

Supply chain disruptions will last until at least 2023

Supply chain disruptions are increasing. There was no real improvement before the war and now, things are getting worse; this is the biggest trend unfolding in front of us. On top of closed and sanctioned Russian mineral exports, several countries are limiting their exports of basic goods. On March 14, Argentina shut down its soya and soy oil exports (41 percent and 48 percent of global exports respectively) for an unlimited period. At the same time, Indonesia tightened export curbs on palm oil—the world's most widely used vegetable oil and used in several food products. Many countries are following the same path, including Serbia, Ukraine, Egypt, Algeria and Bulgaria. Others are still dealing with the pandemic. Shenzhen, China's enormous manufacturing hub and port city, went into lockdown in mid-March. Shenzhen is home to some of China's most prominent companies, including Tencent Holding, operator of the popular WeChat message service, and the electric car brand BYD Auto. It's also the fourth largest port in the world by volume with the transit of 15 percent of Chinese exports. It could take six to eight weeks to clear the backlog; a sustained improvement in international shipping is only expected in 2023 onwards when new containers will arrive in the market. Port congestion is not the only driver of inflationary pressures. In the past few months, we have mentioned several times that the European green transition is fundamentally an inflationary shock for the European households and companies (see our Q1 outlook). Instead of the COP26 resulting in a phasing down of coal, the sad reality is that coal and gas are growing. Hopefully, the Ukraine war will lead to a rethink of the Germany and Belgium nuclear phase-out, but it will take at least 7 to 10 years before new nuclear power stations are operational. In the interim, inflation will remain a headache.

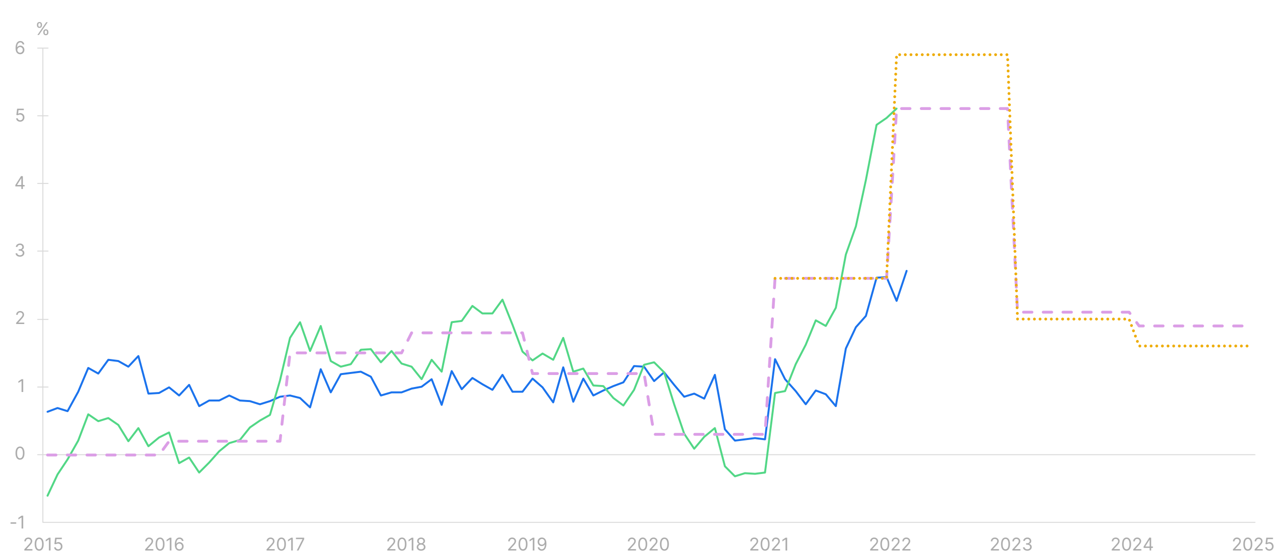
History doesn't repeat itself, but it does rhyme

In our view, comparing today's inflation with the 1970s or the 1973 oil crisis does not make sense. There are at least two main differences: the Covid-19 policy mix in the developed world was out of all proportion to what we have known in the past, and there's no price-wage loop in most euro area countries. In the 1970s, wages were automatically indexed to inflation. This is not the case anymore, with a few exceptions (in Cyprus, Malta, Luxemburg and Belgium, indexation is based on core CPI). So far, wage negotiations in euro area countries have led to an average increase below inflation (less than 1 percent in Italy and between 2 and 3 percent in the Netherlands, Austria and Germany, for instance); this is not the stagflation we experienced in the 1970s. Some economists call this new period the Lowflation. We call it the Great Erosion: erosion of purchasing power, corporate margins and growth due to the explosion of supply costs at the global level. This is the fifth regime shift over the past twenty years: the Great Moderation, the housing bubble, the Secular Stagnation and the Taper Tantrum were the other four. The main question now is who will bear most of the cost. Our bet? Corporate margins. What could prevent this? Basically, we need productivity gains. Unfortunately, we don't see strong evidence in the data of sustained productivity gains from remote work, and whether the green transition will have a net positive or negative effect on productivity is debatable.

The inflation/recession dilemma

All the central banks are officially committed to fighting inflation—this is obvious. The hawks clearly took control of the ECB narrative at the March meeting, but some central banks are certainly more committed than others. We suspect they could take a sustained 3-4 percent annual inflation rate rather than engineering a recession to get them lower. This means they could bluff about it staying hawkish in words rather than deeds. This is certainly more the case for the US Federal Reserve than for the ECB. Don't forget inflation above the last 20-year average has a positive impact on the debt burden too; this is an added bonus. After the Global Financial Crisis of 2007-08, many countries tried the conventional way to reduce debt—meaning austerity and structural reform. It has failed and now it's time to adopt a more unconventional approach: inflation, repression and, in a few cases, default. This will have major implications in terms of investment (outweigh commodities and real estate amongst other options) but also fiscal policy with increased income redistribution for the lowest quintile of households. Not everyone is prepared for what is coming: a prolonged period of high inflation before it drops.

Chart 1 : Euro Area Inflation and ECB Forecasts



Source: Macrobond, Saxo Bank Research & Strategy

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